



PORTFOLIO CONSTRUCTION

Quick Clips: The Stock/Bond Correlation

Q2 2022

The relationship between stocks and bonds has long been a crucial measure for portfolio management in traditional portfolios. For the past two decades, the stock/bond correlation (SBC) has been consistently negative, and investors have been able to rely on their bond investments for portfolio protection when equities sell off. However, macroeconomic changes – like heightened inflation risk – could push this key asset allocation input into positive territory.

The relative importance of growth to inflation uncertainty will be a key driver of the stock/bond correlation (00:30):

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Inflation risk has been top of mind for many investors, and a lesser known consequence of heightened levels is the potential for a positive stock/bond correlation. A positive correlation could impact overall portfolio risk and require adjustments to current allocations.

A positive stock/bond correlation may drive portfolio risk higher, which may impact stock allocations (00:35):

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With reduced diversification between stocks and bonds, we think investors should re-evaluate their overall portfolio allocations. In this challenging environment of high valuations, monetary policy tightening and heightened macroeconomic risks, alternatives may be a good solution to help manage risk and enhance portfolio returns.

Investors may need to look to their alternative allocations to provide diversification (00:29):

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So what is the longer-term outlook and how can investors prepare? While the SBC has trended upwards, a prolonged shift would require longer-term inflation uncertainty coupled with additional shocks or monetary policy errors. This scenario remains a tail risk for investors, and we believe that awareness of the SBC drivers and investment implications, as well as rethinking a portfolio's diversifiers will be critical to navigating a changing SBC.

The SBC outlook is one of several tail risks for investors (00:42):

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